

IDS RESEARCH SUMMARY

Research findings at a glance from the
Institute of Development Studies

IDS WORKING PAPER 307
JULY 2008

Idealism, Realism and the Investment Climate in Developing Countries

How can public action bring about substantial increases in productive private investment within the political and institutional environments typical of poor countries? This Research Summary shows how Working Paper 307 answers that very question. Offering a practical approach to key issues in investment climate reform thinking, the paper suggests a political approach which concentrates on the relationships between investors and policymakers.

Mick Moore and Hubert Schmitz, the papers authors, are both professorial fellows at IDS. Their paper reviews what is meant by the investment climate and then concentrates on the institutional dimension of investment climate reform. Dominant policy advice usually recommends an improvement of the climate itself. The authors agree with this view, however disagree with the big push for an introduction of formal rules at the heart of much investment climate reform. The paper therefore draws on cases in which substantial increases in investment occurred even though property and contracts were not legally protected.

It is suggested that that there is an orthodox view about how institutional reform should proceed and that this view is not trustworthy. The authors' disagreement is not over goals but the methods and processes of reaching goals. The orthodox view provides both guidance about the general direction of

desirable policy reform and bits of practical advice. However this paper argues that governments cannot assume that such conventional advice can be translated into a set of policies that will actually generate more private investment. In particular, they should be aware that in practice it is often very difficult to actually implement the recommended reforms.

Unorthodox and successful

To illustrate that there are feasible alternatives to the orthodox investment climate advice the authors present a case study of China. The country has been enjoying unprecedented high rates of economic growth largely driven by very high levels of profit-seeking domestic investment. The paper outlines how investors in China, who are dominantly Chinese and increasingly 'private' actors in the conventional sense of the term, have enjoyed very little protection through law. Chinese authorities worked out a series of

compromise arrangements that worked well enough for limited periods of time. Emphasis was placed on solving immediate problems through manipulating existing institutions.

Problems with orthodoxy

The paper moves on to deconstruct ideas that underlie the orthodox view, enabling a better understanding of its biases, weaknesses, and strengths. Concerns over reducing cost and reducing uncertainty can lead to practical problems and there is a need for consistent terminology in this area. Legal formulation and state minimisation are additionally examined and the authors warn that they might in practice do little to encourage private investment. This is due to a variety of interrelated reasons including past experience which shows that it is very difficult to bring about effective, rapid reform of weak legal institutions.

“ Governments cannot assume that such conventional advice can be translated into a set of policies that will actually generate more private investment ”

“ Instead of assuming that government and politics are persistent threats to capital and economic growth, the authors suggest that politics and business need one another ”

In adopting relatively ambitious standardised reform programmes, governments may be trying to do too much too quickly.

Business and politics: interdependence

An alternative view of the relationship between government and business is considered. Instead of assuming that government and politics are persistent threats to capital and economic growth, the authors suggest that politics and business need one another. Business needs the support of government to make profits; governments and politicians need to share in these profits to finance government and politics. Even where institutions generally are weak, politicians and business have strong incentives to seek mutually beneficial arrangements that will give investors the confidence to invest and politicians some assurance that they will be able to share in the fruits of this investment. These arrangements can take a variety of forms. The authors highlight how research and knowledge of these relationships is lacking because they have often been dismissed for not meeting what are usually believed to be the right standards of transparency, legality and fairness.

This paper argues for greater recognition of unorthodox ways forward, it suggests a political approach which concentrates on the relationships between investors and policymakers emphasising that sequences and stages matter in this process. The authors consider whether 'getting the institutions

right' comes first or whether investment and growth leads to demand for institutional transformation. Finally the paper warns that this is a field which has been characterised for too long by lots of advice and little serious research. The conclusions brings together some of the key issues that future research needs to address and indicates ways of conducting such research.

Key research implications include:

- an examination of individual countries with poor investment climates yet substantial increases in investment is needed
- there are potential benefits in examining countries where the investment climate has improved substantially and then reconstructing processes which led to the reform
- it is important to remember that countries are not just concerned with the level of investment but the quality of investment
- intra-country comparisons are useful for examining the impact of governance variables and thus gain a clearer idea of attribution

Credits

Mick Moore and Hubert Schmitz, 'Idealism, Realism and the Investment Climate in Developing Countries', Research Summary of Working Paper 307 July 2008

The opinions expressed are those of the authors and do not necessarily reflect the views of IDS or any of the other institutions involved.

Readers are encouraged to quote or reproduce material from issues of IDS Working Papers in their own publications. In return, IDS requests due acknowledgement and a copy of the publication.

The full text of this IDS Working Paper is available from the IDS Bookshop:
www.ids.ac.uk/ids/bookshop/wp/wp307.pdf

© Institute of Development Studies, 2008.